February 3, 2005

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Re: Regulation NMS - File No. S7-10-04

Dear Mr. Katz:

Bernard L. Madoff Investment Securities L.L.C. appreciates the opportunity to offer some additional insight into one specific component of this timely and critically important proposal. We would like to thank the Commission for allowing us to participate in its earlier round table discussions on this proposal last April. We believe that the open dialogue has allowed the industry and those representing the public investor to participate in discussions which have helped define the precepts and objectives of a truly fair and efficient National Market System (NMS) for the future.

We applaud the Commission's proposal to limit protection to only those quotes that are immediately and automatically accessible through automatic execution, with no human intervention in the process. Under the proposal's definition, a trading center's quotation may not be deemed automated unless the trading center: (1) immediately and automatically executes an incoming order up to the quotation's displayed size and cancels any unexecuted portion of the order; (2) immediately and automatically sends a response to the sender of an order indicating what action has been taken with respect to the order; and (3) immediately and automatically updates it's quotation to reflect any change in its terms. The proposal would also require that quotes be appropriately flagged as either manual or automated.

However, we strongly feel that the Commission must recognize and extend the distinctive benefits of automated quotations to all facets of the proposal, and not provide equivalent treatment (and perhaps undue advantages) to those markets that will continue to participate in the NMS by maintaining manual quotations, even after Regulation NMS is approved and implemented. This equivalency (and perhaps advantage), which is wholly inappropriate, results from the Commission's insistence in the reproposed release that manual quotes remain not only a part of the NBBO, but also on parity with automated quotations in the context of a best execution analysis. For the reasons set forth below, we respectfully request that the Commission review and reconsider their position in this context, and revise the trade-through rules or interpretations accordingly.

Distinguishing Automated Quotes

The Commission has proposed trade-through rule changes in several different areas with a common theme: distinguishing quotations that are automated. For example, by carefully defining automated quotations and applying new and stringent standards with respect to their protection under the trade-through rule proposal, the Commission is clearly making a distinction as to their value and stature relative to manual quotations in the NMS of the future. By only protecting automated quotations, the Commission is explicitly acknowledging that manual quotations do not offer the level of certainty and timely responsiveness to warrant protection. If the trade-through rule were to require similar protection for manual quotations, the order senders would be forced to wait for a response from a manual market, and may miss both the best price of a manual quotation and slightly inferior prices that may have been immediately accessible, frustrating the goals of the trade-through rule.

In addition, the proposing release speaks to the distinction between manual and automated quotes in the context of market data revenue allocation. Specifically, the Commission has proposed to exclude manual quotations from any share of the revenue allocation resulting from market data fees predicated on the fact that manual quotations may not be providing market information equal to that of automated quotations.

Furthermore, the proposing release seeks to limit access fees for accessing quotations, thus reducing their distortive effects, but only with respect to those quotations that are protected under the proposed definition (i.e. automated).

The Commission has stated that the intent of the proposal is to implement a major overhaul of the existing structure of the NMS. The Commission states that the overhaul is necessary to respond to the sweeping changes that have reshaped the equity markets in recent years. The impact of expanded communications and trading technology, not the least of which are sophisticated order-routing and execution systems, has enabled trading centers to offer near instantaneous response to and executions of incoming orders.

If this vision is to be fully realized we believe that the Commission should reconsider the impact of according manual quotations virtual parity with automated quotations for inclusion in the National Best Bid and Offer (NBBO) and SEC Rule 11(A)(c)1-5 best execution analysis.

Manual quotations should be excluded from the NBBO

The commission has noted that one of its concerns in response to previous commentators' request for removal of manual quotations from the NBBO is that firms use the NBBO to price investor orders, particularly those of retail investors. The staff has stated that manual quotations are deemed to be firm and, therefore, broker-dealers must honor those quotations.

The Commission has also voiced concern that the elimination of manual quotations from the NBBO would potentially lead to wider spreads in many stocks. Although narrower spreads are a desirable goal, that alone should not be the overriding rational for recognition and inclusion in a truly competitive national market system structure in today’s highly automated and technology driven world.

The expectation of narrower spreads that these manual quotes may provide will have to be weighed against the market inefficiencies that inevitably must accompany any efforts to assess and access those quotes. The Staff has already noted within this release that efforts to execute against manual quotations may result in a failure to obtain an execution not only against the manual quotation but also against other slightly inferior but automated quotations. It also will have the effect of hindering, if not totally eliminating, the benefits of today’s highly automated intelligent routers which have been cited by the Commission and many commentators as a critical component in achieving all of the benefits of a truly efficient, fair and equitable NMS.

Every marketplace is capable of automating their quotations. Those that choose not to provide fully automated quotations have made that decision based on their own perception of what structure will provide them with the most unique and attractive product offering within the NMS. If a market chooses to offer manual quotations, it should not get the advantage of equal status with those quotations that are not only firm but automated as well. Investors who choose to use the facilities of a market that offers manual quotations must recognize and bear the burden of choosing this particular market structure, which not only will not qualify for protection, but also may not provide them with the speed and certainty of execution that automated markets provide.

If quotations are to be taken seriously they must be automated as well as firm to be deemed worthy of inclusion and competitive protection in a truly fair and equitable NMS. By allowing manual quotations to be part of the NBBO, the Commission is not just sanctioning manual quotation but is giving an advantage to those quotations over that of automated quotations. By requiring firms to consider manual quotations in their routing decisions, firms will be indirectly forced to route to or compete against manual quotations that are not only highly suspect as to their certainty of execution and timely response but have already been deemed by the commission to be not worthy of trade-through protection. Therefore, it should follow that the routing of an order to a manual quotation should be at the discretion of the routing firm based on their regular and rigorous analysis in conjunction with prior experience and knowledge with regards to accessing manual quotations within the executing market center.

<u>Manual quotations and "Best Execution"</u>

The Commission's intent, as reflected in Regulation NMS, is clearly seeking to encourage certain behavior in the marketplace, with the goal of enhancing the overall benefits of a linked and more automated, NMS. This is sure to result in a vastly improved and more efficient market in terms of its ***mechanics and structure***. However, the Commission has not extended this clear theme to what arguably could be the most important element in the NMS: ***<u>best execution</u>***. Specifically, the Commission failed to take into account the differences between automated and manual quotations in the context of a best execution calculus. Consequently, we strongly suggest that this distinction be made, as set forth below.

The Commission has emphasized that the adoption of the trade-through rule would in no way lessen a broker-dealer's duty of best execution. They go on to state that broker-dealers must seek the most advantageous terms reasonably available under the circumstances for their customers' orders. They emphasize that broker-dealers must carry out a "regular and rigorous" review of the quality of markets to evaluate their order execution policies, including their decisions concerning which markets to route customer orders to.

The benchmark for these best execution evaluations is Rule 11(A)(c)1-5. The predicate for this rule is the NBBO, from which all statistical order execution analysis evolves. The inclusion of manual quotations in the establishment of the NBBO component measurement for each trade is unfair and inconsistent with the overall approach of Regulation NMS. It is simply unreasonable, and perhaps irrational, to give equal standing in a benchmark NBBO to a quote that is not automated and not immediately accessible as defined by the trade-through rule. If manual quotations are not deemed worthy of trade-through protection how can they be deemed to be equal to those quotations that are fully automated and compliant with the trade-through rule?

This is not to say that manual quotations should not have a place in the NMS. The proper place for evaluating the potential benefits of accessing manual quotations and any resultant executions, however, should be similar to that accorded opportunities for price improvement. In other words, their value will be measured in terms of their contribution to a market center's price improvement (or disimprovement) statistics. Price improvement is deemed to be executions achieved at prices within the NBBO. It is not deemed to be part of the original benchmark quotation defining the NBBO. Price improvement opportunities have been recognized by the Commission as an important component in the analysis of best execution. Executions achieved at prices better than the NBBO accrue to the benefit of the effective spread analysis for each executing market center. The more executions achieved at prices superior to the NBBO, the better statistics that executing market center will present to those broker-dealers who are charged with making a regular and rigorous best execution analysis as defined by SEC Rule 11(A)(c)1-6.

Furthermore, the regular and rigorous comparative analysis of best execution for routing purposes is not meant to be measured on a trade by trade basis but rather on a cumulative assessment based on standardized data represented in monthly statistics posted by executing market centers as defined by Rule 11(A)(c)1-5. It would, therefore, be inconsistent with this analysis to have to evaluate individual trade by trade executions as benchmarked by manual quotations. The execution of manual quotations is similar to achieving executions at improved prices; they are not certainties. These executions, when and if achieved are represented in the calculations of the effective spread, but they are not the basis of the benchmark NBBO.

If manual quotations are deemed to have equal standing to fully automated quotations and included in the benchmark NBBO we are concerned that the commission will have effectively changed the best executions standards as they relate to a regular and rigorous analysis of best execution. The trade-through rule allows the broker-dealer to make an assessment as to efficacy of manual quotations based on a regular and rigorous analysis that is not subject to a trade by trade assessment. However, based on language in the release we are concerned that customers and regulatory examiners will hold broker-dealers liable to a best execution standard far beyond the scope of the trade-through rule and the present requirements of a best execution analysis.

For this reason we urge that the Commission clarify its position by providing specific guidance as to the interplay between the trade-through and the best execution requirement. Continued application of the requirements of the best execution rule should not be viewed or construed as overriding or eviscerating the progress manifested in the Commission's proposal. Clarity of purpose and application is critical in this regard.

Manual quotations and access fees

The availability of access fees and any appropriate limitations should be applicable to all quotations, and not just those quotations that also warrant trade-through protection. This will ensure that all quotations are treated fairly. Those competing executing market centers would be required to provide reasonable access to their manual quotations, enabling a broker-dealer to fulfill its requirements to provide best execution for its clients' orders.

Even if manual quotations were to be excluded from the NBBO and not included as a direct component of the calculation of Rule 11(A)(c)1-5 statistics, as we argue herein, their potential contribution to a market center's execution quality could potentially require firms to consider accessing these quotations. Order senders with this regulatory obligation should not be disincented from attempting to access these quotations due to the imposition of an unreasonable tariff imposed by the market representing these manual quotations. Thus the limitations on these fees should apply to all quotes, including manual ones.

By extending the fee limitation to manual quotations the Commission would be achieving its goal of precluding outlier or predatory business models. Those markets choosing to offer manual quotations would be forced to provide truly value-adding services and find other means of funding their operations. It would also further the goals and statutory purpose of Regulation NMS by enabling broker-dealers to route orders consistent with the trade-through rule.

In conclusion, we applaud the Commission's efforts to provide new trade-through rules that would significantly improve the fairness and efficiency of the NMS of the future. Furthermore, we especially appreciate the Staff's willingness to engage in extended open dialogue as well providing ample opportunities for written response. We hope that our comments will be helpful. If you have any questions concerning these comments, or would like to discuss our comments further, please feel free to contact us.

Sincerely,

Bernard L. Madoff   Peter B. Madoff

Cc: Chairman William H. Donaldson
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Cynthia A. Glassman
Commissioner Harvey J. Goldschmid
Annette Nazareth, Director, Division of Market Regulation
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